"Comparing" Private and Public Companies

Revenue Ruling 59-60, the foundation of "fair market value", requires that appraisers consider "market prices" of interests in entities engaged in the same or a similar line of business having their interests actively traded in a free and open market.

Many appraisers blindly use large public companies as benchmarks to value small private companies.

There are seven reasons that this approach has severe limitations:

1. The identification of "similar businesses" is difficult. Public companies are usually more mature, larger and more diversified than private businesses. They have more management depth and financial resources, less concentrated product lines and customer bases, and larger market shares. In short, they are less risky than private companies in terms of fundamentals like cash flow stability.

2. Public and private company investors and equity markets differ fundamentally. Public investors are typically large financial institutions and wealthy individuals with financial sophistication and diversified portfolios. Private company investors' major investment by far is the stock in their companies. Public investors have shorter time horizons and enjoy deeper markets and greater liquidity. They focus almost exclusively on earnings, cash flow, dividends and appreciation, while private company investors also consider asset values and many other intangible factors. Private company owners can maximize their benefits through salaries and other perquisites almost without regard for earnings. For very small businesses, buyers' motivations are often to obtain jobs, not to maximize earnings or equity values. Public investors may protect themselves with put and call options, stop loss and limit orders. Private investors cannot do so, which makes their investments far riskier. Their investment liquidity is thus seriously impaired and highly uncertain.

3. Most public investors own small portions of large businesses. They do not control them. They benefit only from stock performance *(dividends and price appreciation)*. They are also at risk for far greater price volatility. Private investors typically purchase substantial or complete interests, manage them actively and benefit directly from performance in the form of higher compensation.

4. The quantity and quality of information available from public companies *(which are required to follow formal, detailed Securities and Exchange Commission disclosure requirements)* usually exceeds that available from private companies.

5. Public companies generally tend to sell at higher valuation multiples than do private companies. As a result, appraisers using large public companies as comparables must make large reductions to public company multiples in order to arrive at reasonable private company values. It is very difficult to substantiate them, which weakens their credibility.

6. Revenue Ruling 59-60 was written over 40 years ago. At that time, there was virtually no data available on "private comparables"; that is, sale prices of private companies. Today, there are many databases with such information that appraisers can use. This information is a much better fit with the reality of private company valuations.

7. Comparables are part of the Market Approach, one of three basic valuation approaches. The others - Income and Asset – are equally valid and may supersede Market Approach results.

The bottom line: because public companies are not always comparable to private companies, other data, and approaches must always be considered.